BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
TOOL RESEARCH AND)
ENGINEERING CORPORATION)

For Appellant: W. C. Bertrand
Vice President - Finance

For Respondent: Crawford H. Thomas
Chief Counsel

Marvin J. Halpern
Counsel

OPINION

This appeal is made pursuant to section 25667 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Tool Research and Engineering Corporation against a proposed assessment of additional franchise tax in the amount of $25,060. 15 for the income year ended July 31, 1963.

The issue presented is the propriety of respondent's action which is based on a federal determination, to the extent the federal adjustments increased income, and disallowed certain accrued costs and rental expenses.

Appellant's federal returns for the period September 1, 1959, through July 31, 1960, and for subsequent fiscal years through July 31, 1964, were audited and adjustments made by the Internal Revenue Service. Subsequently, the Internal Revenue Service made certain revisions in the federal audit, and that matter was settled. Proposed assessments were issued, and then revised, by respondent for the income years ended July 31, 1961, and July 31, 1963, to conform to the federal adjustments, with the exception of certain net operating loss carrybacks not provided for in California law. Appellant has appealed only from respondent% action as to the income year ended July 31, 1963.

The first disputed item concerns receipts of $250,481.48 which appellant did not consider as constituting gross income. Although the record in this entire case is meager, we do know that appellant, an accrual basis taxpayer, was awarded an Army Ordnance Contract on January 3, 1962, to manufacture M-79 grenade launchers. During the year in question, appellant received: the above amount.. which, it claims, represented progress payments based upon a percentage of costs that it had incurred in performing the contract. There is no evidence that the amount was received with any restriction as to use, The government terminated the contract on August 20, 1963, for alleged default, and demanded return of progress payments. Appellant refused, and as a result of litigation, appellant was allowed to retain the receipts.- It was evidently established that appellant was not in default. Appellant never reported the $250,481.48 as gross income, but the Internal Revenue Service treated it as such for the fiscal year ended July 31, 1963.

Appellant explains that it had not delivered any launchers, and contends under its accounting method for long-term contracts it properly accounts for income based only upon units delivered and the associated sales prices, regardless of when money is received. It explains that progress payments are common in long-term government contracts, and maintains they normally serve to reimburse for.costs incurred with no direct relationship to the sales price of a contract..

The second disputed item concerns disallowed accrued costs of $75,000.00. After the government terminated the contract, appellant prepared a. schedule purporting to indicate- liabilities, as of July 31, 1963, due to its subcontractors. The schedule heading reads, in part, "computation of amount of possible loss on subcontracts. " One column, headed "Estimated buy-off", totals $150,000.00.

Appellant claims that the liabilities due subcontractors arose from termination of the contract. Appellant estimated liability at 50 per-. cent of this amount as of July 31, 1963, claiming the liability resulted from classifying the parts on the schedule into various' states of completion. It asserts there was no question as to the existence of a fixed liability but only as to the precise amount. Appellant paid $42,108.20 to the listed subcontractors in the next fiscal year. Certain contested amounts were also paid thereafter.

The third disputed item is disallowed rental expense of $114,900.00. Appellant leased two buildings which it used exclusively to manufacture the launchers. As a result of the contract termination appellant says it "abandoned" these properties. As of July 31, 1963, the lease had 25 1/2 months to run, the monthly rental obligation being $7,800.00 or $198,900.00 for the balance of the term. Appellant has referred to a possible sublease for 24 months with potential income of $84,000.00. Appellant deducted the difference between these two amounts as accrued rent expense for the appeal year. It urges that because of the changed business conditions the lease became worthless (except as to the potential sublease), and it is entitled to treat the $114,900.00 as a loss or an accrued expense. It made its last regular monthly rental payment in October of 1964. A final payment of $32,500.00 was made in August of 1967, resulting from a lawsuit initiated by the lessor.

In resolving this appeal, we must consider the well established rule that a deficiency assessment issued by respondent on the basis of federal action is presumed correct, and the burden is on appellant to overcome the presumption. (Todd v. McColgan, 89 Cal. App. 2d 509 [201 P.2d 414]; Appeal of Jackson Appliance, Inc., Cal. St. Bd. of Equal., Nov. 6 1970; Appeal of Nicholas H. Obritsch, Cal. St. Bd. of Equal., Feb. 17, 1959.) Appellant urges that the federal action was incorrect, and settlement was made only because it could utilize net operating losses from another period against the federal liability. It claims that no purpose would have been served in continuing negotiations. It must be noted, however, that after the revision there was an uncontested deficiency in federal tax exceeding $150,000.00 for the fiscal year ended July 31, 1963, even after applying a net operating loss carryback from the subsequent fiscal year.

In any event, irrespective of appellant's reasons for agreement, on the basis of the limited record before us, we cannot conclude that appellant has overcome the presumed correctness of

the federal audit. With respect to the disputed income item, we note that both federal. and state regulations. authorize two special methods of reporting income from long-term contracts regardless of when money is received; provided the method, chosen clearly reflects income,_ One, is the percentage.- of completion method, whereby the portion, of the gross contract price which corresponds. to the -percentage of the entire contract.. which. has been completed during the year, is included in gross income. Under the. other method (which appellant concededly does, **not** use) gross income is reported for the year in which the contract is finally completed and accepted. (Treas. Reg. §1. 451-3; Cal. Admin. Code, tit. 18, reg. 24661(c).)

The percentage of completion method is essentially an accrual method of determining income under long-term contracts. (South Coast Co. v. Franchise Tax Board, 250 Cal. App. 2d 822 [58 Cal. Rptr. 747].) --Under a long-term unit price contract, if accurate cost records are kept, a taxpayer may determine gain or loss on. the basis of each unit completed (substantially a percentage of completion method); provided such method clearly reflects income. : (Anderson-Dougherty-Hargis Co. v. United States, 96 F. Supp. 404.)

Appellant; however, simply has not established that its method clearly reflects income. The provisions of the **contract** are not part of. the record. We can only speculate concerning their content. For example, the timing and application of progress payments may have matched actual progress, and thereby reflected income, or only a part of the income -that had realistically accrued, Units may have been substantially completed but not delivered. Work may have been performed on many units although none were finished, so that income equivalent to the percentage of completion should have been reported. (Cf. South Coast Co. v. Franchise Tax Board, supra; Appeal of South Coast Co., Cal. St. Bd. of Equal., May 17, 1962.) The nature. and effect of title, acceptance, and inspection clauses in the contract, and. the condition of appellant's books and records, may not have supported-a "units delivered" method as clearly reflecting income. In. short, appellant, simply has not rebutted the presumption of correctness.

Since a proper long-term contract method of accounting has not been established, the advance payments received without restriction as to use, by this accrual basis taxpayer for goods to be delivered in the future, were. includible in income when received.

(Hagen Advertising Displays, Inc. v. Commissioner, 407 F. 2d 1105; Fifth and York Co. v. United States, 234 F. Supp. 421; S. Garber, Inc., 51 T. C. 733; Chester Farrara, 44 T. C. 189; Wallace A. Moritz, 21 T. C. 622; Appeal of Brand, Worth & Associates, Inc., Cal. St. Bd. of Equal., Aug. 30, 1967.) There have been some views to the contrary but such holdings are in the' minority and involve unique facts. (See, e.g., Consolidated-Hammer Dry Plate & Film Co. v. Commissioner, 317 F. 2d 829; Veenstra & DeHaan Coal Co., 11 T. C. 964.) Therefore, we must conclude that respondent properly followed the federal audit as to this item.

We next consider the disallowed deduction for accrued costs of $75,000.00. The previously mentioned schedule simply does not reveal how appellant arrived at the percentage of completion estimates or the accrued liability. Furthermore, it is only a work-sheet "of amount of possible loss on subcontracts. " In addition, appellant apparently regarded these liabilities as accruing because the contract terminated, an event occurring in the subsequent fiscal year. Under the accrual method of accounting, deductions are allowable for the year when all the events have occurred which establish the fact of the liability giving rise to such deduction and the amount thereof can be determined with reasonable accuracy. (Treas. Reg. 1.446-1(c)(ii); Cal. Admin. Code, tit. 18, reg. 24651, subd. (c)(l)(B).) Clearly, appellant has not established this as having occurred in the income year ended July 31, 1963. We conclude that respondent had no alternative but to adopt the federal action as to this second item.

Our next consideration is whether the $114,900.00 rental expense claimed was properly disallowed. The government did not cancel the contract until August 20, 1963, which was after the fiscal year in question. The last regular monthly payment was made in October of 1964. These facts do not support the allegation that the leasehold (without considering possible sublease value) became worthless during the appeal year, entitling appellant to an abandonment loss or to accrue this amount as rental expense for the fiscal year in question. Accordingly, respondent again proceeded properly in following the federal audit as to this item.

Finally, we note also that appellant has alleged "the proposed assessment was incorrectly allocated as 100 percent to California. " Appellant, however, has submitted no evidence in support of this allegation and it is well established that a taxing

authority's determination of a factual question is presumed correct, and the burden is on the taxpayer to prove it erroneous; (Hoefle v. Commissioner, 114 F. 2d 713.)

ORDER

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section -25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board. on the protest of Tool Research and Engineering Corporation against a proposed assessment of additional franchise tax" in the amount of $25,060. 15 for the income year ended July 31, 1963, be and the same is hereby sustained.'

Done at Sacramento, California, this 17th day of December, 1974, by the State Board of Equalization.

Chairman

Member

Member

Member

Member

ATTEST: Secretary